Internal Revenue Service

Number: **201325007**
Release Date: 6/21/2013

Index Number: 165.00-00, 165.06-02

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B03
PLR-143168-12
Date: March 18, 2013

In Re:

Legend:

Date 1 =

Taxpayer =

Company =

State A =

B =

C =

State B =

Year 1 =

D =

E =

F =

G =

H =

J =

K =

L =

Year 2 =

M =

N =

O =

Dear :

This is in response to your representative's letter dated Date 1, submitted on behalf of Taxpayer, requesting a ruling that the gross receipts from License Fees received by the Company under its third party licensing arrangements are excluded from the definition of "royalties" under § 165(g)(3)(B) of the Internal Revenue Code.

FACTS

Taxpayer, a State A corporation, is the common parent of a U.S. consolidated tax group. Taxpayer develops, manufactures, and markets B products for the C markets.

Company is a State B corporation and, since Year 1, a wholly-owned subsidiary of Taxpayer. Company is a D company that

Since its incorporation, Company's business has focused on research and development. Company conducted proprietary research through its own scientists and through collaborative arrangements with scientists at universities worldwide. Company employed scientists with expertise in

Under Company's historic business model, once Company discovered and/or developed a E through its research and development activities, it applied for patent protection. The E discovered and/or developed by Company were further developed and if successful, commercialized through licensing or joint ventures with major F companies which have greater resources than Company, particularly in the areas of regulatory approval, mass-production and marketing.

Under these licensing arrangements, Company undertook research programs with the goal of developing commercially viable products. In general, Company would develop a E through pre-clinical research. After obtaining promising data from laboratory studies in the pre-clinical research, a G would be submitted to the J, or foreign equivalent. Under the licensing or collaboration agreements, Company would assist in the performance of clinical trials. Successful clinical trials would lead to submitting an H with the J in order to bring the K to market.

Under the terms of a typical licensing agreement, Company received an up-front payment as consideration for the value created from Company's research and development activities, and milestone payments as the K progressed through the J approval process. Once the drug was approved by the J and then introduced to the market, Company received additional payments either based on fixed amounts or as a percentage of the sales of the new product. These additional payments along with the up-front payment and the milestone payments constitute the "License Fees" at issue in this ruling request. The fee arrangement under the licensing agreements is consistent with the general practices in the D industry.

Company used License Fees to fund research for other projects including it's flagship product, L. In Year 2, questions about the safety of L caused sales to fall dramatically. In response, Company undertook one of the largest clinical trials in M to explore concerns raised about L. Although the trial demonstrated the safety of L, its sales never recovered and Company is in the process of discontinuing business operations. When Company finally ceases business activities, Taxpayer represents that it expects that the stock of Company will be wholly worthless.

RULING REQUESTED

Company's gross receipts from the License Fees under its third party licensing arrangements are excluded from the definition of "royalties" within the meaning of § 165(g)(3)(B) of the Code.

LAW AND ANALYSIS

Section 165(a) of the Code allows as a deduction any loss sustained during the year and not compensated for by insurance or otherwise.

Section 165(g)(1) of the Code provides the general rule that if any security which is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security to include a share of stock in a corporation.

Section 165(g)(3) of the Code provides an exception to the general capital loss rule and allows a Parent that is a domestic corporation to claim an ordinary loss for worthless securities of an "affiliated" corporation. *See also* § 1.165-5(d) of the Income Tax Regulations. Under § 165(g)(3), a corporation is treated as "affiliated with the Parent" only if--

(A) the Parent owns directly stock in the corporation meeting the requirements of § 1504(a)(2) (i.e., at least 80 percent of the voting power and value of the corporation's stock) ["ownership test"], and

(B) more than 90 percent of the aggregate of the corporation's gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities ["gross receipts test"]. *See also* § 1.165-5(d)(2)(iii), which provides that the gross receipts test applies for all the taxable years during which the subsidiary has been in existence.

The gross receipts test was designed to determine whether a subsidiary is an operating company (for which an ordinary loss may be allowed) or a holding or investment company (for which an ordinary loss is not allowed). The Revenue Act of 1942, Pub. L. No. 754, section 123(a)(1), 56 Stat. 798, 820 (1942), added § 23(g)(4) (the predecessor to §165(g)(3)), to provide for an ordinary loss for worthless stock instead of capital loss treatment of certain affiliated corporations. The legislative history indicates the purpose of § 23(g)(4) was to allow a parent corporation to claim an ordinary loss deduction for the stock of its subsidiary if it becomes worthless, regardless of whether the parent and subsidiary file a consolidated return or not. S. Rep. No. 77-1631, 77th Cong., 2d Sess.

46 (1942), 1942-2 C.B. 504, 543. Section 23(g)(4) included an ownership test and a gross income (changed in 1954 to gross receipts) test.

Shortly after its enactment, § 23(g)(4) was amended by Congress to provide that certain rents and interest earned by an operating company (rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business and interest received on the deferred purchase price of operating assets sold) were to be treated as operating income, rather than passive income, in applying the gross income test. *See* Pub. L. No. 235, section 112(a), 58 Stat. 21, 35 (1944); S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543; 90 Cong. Rec. S121-122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis). In introducing the amendment, Senator Davis noted that Congress' intent in enacting the gross income test was to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company. The intent of the change, as explained by Senator Davis, was to exclude certain rents and interest derived by a company that was solely an operating company from the scope of passive income in accordance with the intent of Congress. The rent and interest from the sources described were viewed as "incidental to the operating activities of the company" and as arising from a "direct result of its activities as an operating company." 90 Cong. Rec. S at 122.

Thus, the legislative history of § 165(g)(3) supports the argument that Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company, and that the terms rent and interest refer to income derived from a passive source. In Rev. Rul. 88-65, 1988-2 C.B. 32, the Service relied upon this legislative history, in part, in distinguishing between receipts from passive investment activities and receipts derived in the ordinary course of conducting an operating business. Under this ruling, amounts received under short-term automobile and truck leases do not constitute rents for purposes of § 165(g)(3)(B) because the leasing subsidiary performed significant services in connection with the leases.

Under the facts of this case, Taxpayer represents that when the Company ceases business activities and becomes wholly worthless within the meaning of §165(g), the ownership test of §165(g)(3)(A) will be satisfied because Taxpayer has directly owned all of the stock of Company since Year 1, and will continue to own the stock until it becomes wholly worthless. Taxpayer requests a ruling that in applying the gross receipts test of §165(g)(3)(B) when the stock of Company becomes wholly worthless under §165(g), gross receipts from the License Fees are excluded from the definition of royalties.

A literal reading of the gross receipts test requires that more than 90 percent of the aggregate of a subsidiary's gross receipts be from sources other than disqualifying, specifically enumerated sources of income, such as royalties. However, the legislative history to the gross receipts test suggests Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company.

Taxpayer represents that Company has been actively engaged in a trade or business since its incorporation. Specifically, Company has used its own employees to conduct proprietary research with the goal of developing E for the treatment of N. Under Company's historical business model, Company discovers and/or develops E through its proprietary research and then enters into licensing agreements with major D companies for collaboration in the further development of E in pre-clinical trials and various phases of clinical trials for purposes of obtaining J approval. The License Fees received by Company funded its continued operations and helped support future research.

Thus, Taxpayer argues unlike the situation where a passive investor merely acquires and licenses intangible property for royalties, Company performed substantial services and remained actively involved in the research and development of the product under licensing arrangements. In exchange for its significant research and development activities for the product the Company has received License Fees in the form of up-front fees, milestone payments, and post-J approval fees either based on a fixed amount or a percentage of the sales of the products under the licensing arrangements. Taxpayer also argues that the active or passive analysis of Rev. Rul. 88-65 applies to the License Fees of Company because Company performed substantial services and remained actively involved in the research and development of O under the licensing arrangements.

Based on the facts submitted and the representations made, we conclude that the License Fees earned by Company are fees attributable to the Company's significant business activities in the research and development of F products for J approval and arise as a direct result of its activities as an operating D company. Thus, Company's gross receipts from the License Fees should be excluded from the definition of "royalties" within the meaning of § 165(g)(3)(B).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit or examination process.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

ROBERT M. CASEY
Senior Technician Reviewer, Branch 3
Income Tax & Accounting